

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 93-503-C - ORDER NO. 94-1229✓
DECEMBER 5, 1994

IN RE: Investigation of Level of Earnings) ORDER RULING ON
 of Southern Bell Telephone & Telegraph) INVESTIGATION
 Company.)

This matter is before the Public Service Commission of South Carolina (the Commission) on the Commission Staff's (the Staff's) investigation of Southern Bell Telephone & Telegraph Company's (Southern Bell's or the Company's) level of earnings. By Order Nos. 91-595 (August 20, 1991) and 92-89 (February 24, 1992) in Docket No. 90-626-C, Southern Bell entered into its incentive regulation plan¹ effective January 1, 1992 with a benchmark rate of return of 13.0%. Thereafter, the South Carolina Supreme Court reversed the generic IRP previously adopted by this Commission for telephone utilities under its jurisdiction. South Carolina Cable Television Association v. Public Service Commission of South Carolina, ___ S.C. ___, 437 S.E.2d 38 (1993). Southern Bell's specific IRP was reversed by consent order of the parties. The current Staff investigation of Southern Bell's 1992 earnings was initiated as a result of the Supreme Court's reversal of the generic incentive regulation plan and, specifically, the reversal

1. At times, the Commission will denominate the term incentive regulation plan as IRP.

of Southern Bell's incentive regulation plan.

Pursuant to his August 12, 1994, letter, the Executive Director of the Commission instructed Southern Bell to publish a prepared Notice of Filing once a week for two (2) consecutive weeks in newspapers in the affected areas and provide a copy of the Notice of Filing to each of its customers. The Notice of Filing documented the nature of this proceeding and informed interested parties of the time and manner in which to intervene. Southern Bell certified that it complied with the Executive Director's instructions. The Commission received Petitions to Intervene from the Consumer Advocate for the State of South Carolina (the Consumer Advocate), AT&T Communications of the Southern States, Inc. (AT&T), Sprint Communications Company, L.P. (Sprint), the South Carolina Cable Television Association (SCCTA), the Office of Information Resources of the South Carolina Budget & Control Board (OIR), Marlene J. Sowell, MCI Telecommunications, Inc. (MCI), LDDS of Carolina, Inc. (LDDS), and the South Carolina Public Communications Association (SCPCA).

On August 22, 1994, at 11:00 a.m. the Commission convened a hearing to address the Staff's investigation. The Honorable Rudolph Mitchell, Chairman, presided. F. David Butler, General Counsel, and Gayle B. Nichols, Staff Counsel, represented the Commission Staff; William F. Austin, Esquire, Harry M. Lightsey, Esquire, and R. Douglas Lackey, Esquire, represented Southern Bell; Philip S. Porter, Esquire, and Elliott F. Elam, Jr., Esquire, represented the Consumer Advocate; Francis P. Mood,

Esquire, and Roger A. Briney, Esquire, represented AT&T; Darra W. Cothran, Esquire, represented Sprint; John M.S. Hoefer, Esquire, and B. Craig Collins, Esquire, represented the SCCTA; Craig K. Davis, Esquire, represented OIR; D. Christian Goodall, Esquire, and Martha P. McMillan, Esquire, represented MCI; Frank R. Ellerbe, III, Esquire, represented LDDS; and John F. Beach, Esquire, represented the SCPCA.²

The Commission heard testimony from numerous witnesses in this proceeding. Thomas L. Ellison, Gary E. Walsh, and James E. Spearman testified on behalf of the Staff; E. Brian Killingsworth, Joseph A. Stanley, Jr., Emanuel V. Lauria, Jr., Michael O. Sullivan, and Randell S. Billingsley testified on behalf of the Company; Philip E. Miller, John B. Legler,³ and Allen G. Buckalew testified on behalf of the Consumer Advocate; Wayne A. King testified on behalf of AT&T; Ted Lightle testified on behalf of OIR; and Denise Hales testified on behalf of MCI.

After thorough consideration of the evidence presented at the hearing and the applicable law, the Commission makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. Southern Bell is a wholly-owned subsidiary of BellSouth Corporation. Southern Bell's intrastate telephone operations are subject to this Commission's jurisdiction. S.C. Code Ann. §58-9-10

2. Ms. Sowell did not appear at the hearing.

3. Dr. Legler was co-sponsored by the SCCTA.

to -2320 (1976).

2. Southern Bell's currently approved rate of return on common equity is 13.0%. By Order Nos. 91-595 (August 20, 1991) and 92-89 (February 24, 1992), the Commission set Southern Bell's rates at a level as to provide the Company with the opportunity to earn this return on common equity based on a test year ending December 31, 1989. See, Docket No. 90-626-C.

3. The Staff conducted an audit of Southern Bell's operations for the period ending December 31, 1992, which was the end of the Company's first year of operation under incentive regulation. The Staff computed a rate of return on common equity of 17.31%, after accounting adjustments, and 16.35%, after pro forma adjustments. Southern Bell asserts its return on equity after accounting and pro forma adjustments is 12.22%. Hearing Exhibit 18.

4. The Staff, the Company, and the intervenors proposed various accounting and pro forma adjustments to the Company's revenues, expenses, and investment as represented in Southern Bell's 1992 surveillance report. Consistent with the Commission's desire to review the Company's earnings at December 31, 1992, the Commission will herein address the adjustments made by the parties.

A. Accounting and Pro Forma Adjustments

i. Revenue and Expense Items

A. Pension Expenses. The Consumer Advocate proposed to adjust the Company's pension expense by (\$1,480,000) on the basis that the 1992 pension expense of \$8,359,841 was considerably more than the three prior years and 1993. Neither the Staff nor the Company made an adjustment to Southern Bell's pension expenses.

The Commission adopts the Consumer Advocate's adjustment. The Commission finds the 1993 costs are known and measurable and fairly reflect the ongoing pension expense of the utility. Moreover, as stated later in this Order, use of the 1993 pension expenses is consistent with the Commission's treatment of salary and wages.

B. Company Refund. The Staff proposed to adjust the Company's 1992 revenues by (\$7,637,995) to reflect the refund Southern Bell provided to its subscribers pursuant to the IRP.⁴ The refund was based on the Company's 1992 financial records and was made during December 1993 and January 1994. The Staff proposed to reduce the Company's 1992 operating revenues by \$7,637,995 to recognize the effect of the refund on the Company's 1992 earnings and reflect the refund on a prospective basis.

The Company disagreed with the Staff's adjustment. Company witness Killingsworth explained that Southern Bell proposed to reverse the earnings impact of the refund, thereby increasing

4. Under the Company's IRP, Southern Bell was to refund 50% of any of its earnings between 14.00 and 16.50% to its customers.

intrastate net operating income by \$4,715,536.

The Commission denies the Staff's adjustment. The Commission finds and concludes that because the IRP was reversed by the South Carolina Supreme Court, Southern Bell was not required to refund any revenues to its customers under the incentive regulation earnings sharing scheme. Furthermore, since the IRP has been reversed, Southern Bell will not be issuing refunds on an annual basis. Therefore, Southern Bell's operating revenues at December 31, 1992, should not reflect the refund issued by the Company - and Southern Bell's prospective rates should not be set based on an adjusted level of revenues reflecting the refund.

C. MemoryCall Service. The Staff proposed to disallow the impact of MemoryCall Service during the test year. MemoryCall Service is a central office based feature which provides voice messaging service for business and residential customers through the use of mailboxes. The Staff testified that because the Commission had denied Southern Bell's tariff filing and informed the Company that its decision to offer MemoryCall Service would be at its own risk,⁵ the Commission should disallow the expenses and associated rate base investment for this service offering. During the 1992 test year, Southern Bell incurred tremendous losses associated with MemoryCall Service.

The Company proposed to include all of its revenues,

5. See April 9, 1992, letter from F. David Butler, General Counsel of the Commission, to William F. Austin, counsel for Southern Bell.

expenses, and rate base associated with MemoryCall Service as ratepayer items.⁶ Southern Bell believed the service was regulated by this Commission and had been offered since April 15, 1992 under its General Subscriber Tariff.

The Commission finds that MemoryCall Service should be a regulated service whose rates are approved by this Commission. Nonetheless, due to the large losses generated during the start-up year of MemoryCall Service (which coincides with the 1992 year under review), the Commission concludes that the 1992 revenues, expenses, and rate base associated with MemoryCall Service do not fairly reflect the normal, going forward level of revenues, expenses, and rate base associated with the service. Therefore, the Commission finds it appropriate to adopt the Staff's proposal and eliminate the expenses and associated rate base investment for this service.

D. Area Plus. The Staff proposed to disallow the revenue losses associated with Area Plus, an optional service offering which became available to Southern Bell's residential and business subscribers choosing to expand their local calling area in the last quarter of 1994. The Staff based this adjustment on the fact that the actual losses associated with Area Plus were not known and measurable at the time of the hearing and that Southern Bell had only included estimated losses in its 1992 surveillance report. These losses were estimated to be \$15,376,280 without

6. The Company's proposal increased its revenues by \$345,496, its expenses by \$1,815,954, and its rate base by \$2,247,206.

stimulation.

The Company proposed to include the estimated losses associated with Area Plus to accurately represent Southern Bell's earnings to the Commission. Company witness Stanley explained the basis for the current anticipated losses as a result of Area Plus.

The Commission finds Mr. Stanley's calculation of the Company's estimated losses due to Area Plus credible. Moreover, the Commission concludes that Area Plus is a service offered by Southern Bell as a result of demand by its customers. However, until such time as the Company has some actual experience from Area Plus, the Commission concludes that half of the losses, \$7,688,140, resulting from Area Plus should be borne by the shareholders and the remaining half of the losses, \$7,688,140, should be borne by the ratepayers.

The Commission concludes that its treatment of revenue losses from MemoryCall Service and Area Plus are not inconsistent. MemoryCall Service was voluntarily offered by Southern Bell despite the Commission's representation that, if it decided to offer the service, it would do so at its own risk should the courts reverse the Federal Communications Commission's (FCC's) approval of MemoryCall. See, April 9, 1992, letter from F. David Butler. Area Plus, however, was offered with full Commission approval. See Order No. 93-808 (September 1, 1993), Docket No. 93-176-C.

E. Pioneer Club Expenses. The Staff proposed to disallow the Company's \$89,920 in expenses and rate base of \$12,140

associated with its Pioneer Club on the basis that the Pioneer Club is not necessary for the provision of telephone service. The Company proposed to recover these expenses. The Company explained that the Pioneer Club is "an association of current and retired Southern Bell employees whose volunteer activities are aimed at providing service to the community and building the skills and morale of the employees involved." Killingsworth, Tr. Vol. 6**. Southern Bell asserted that ratepayers do benefit from these volunteer activities.

The Commission concludes that, although improvement of employee morale and skills through volunteer community activity may in some fashion benefit the ratepayer, ratepayers should not be required to fund the expenses of the Pioneer Club. Clearly, the Pioneer Club is not necessary for the provision of telephone service. The Commission adopts the Staff's adjustment.

F. Employee Newsletter. The Company proposed to recover the costs associated with the publication of its employee newsletter. The Staff proposed to disallow this expense. The Staff's disallowance was \$29,959.

The Commission concludes that while an employee newsletter may be of benefit to the Company's employees, its expense should be borne by the shareholders. An employee newsletter is not necessary for the provision of telephone service. The Commission adopts the Staff's adjustment.

G. Casualty Reserve Fund. Southern Bell proposes the establishment of a casualty reserve fund to protect the Company

and its customers from loss due to a hurricane or other extreme weather phenomena. The Company proposes an annual expense of \$10 million to establish this fund until a total of \$50 million is reached, or whatever other amount the Commission deems reasonable and prudent. Tr. Vol. 6, p. 116, line 23 - p. 117, line 2.

The Commission believes that Southern Bell presented convincing evidence that South Carolina has historically had repeated encounters with Atlantic Ocean hurricanes and other extreme weather phenomena. Because of this, there is a considerable risk to Southern Bell's outside plant in South Carolina because of the likelihood of a hurricane, ice storm, or flood. The study conducted by witness Michael O. Sullivan of this exposure shows that the loss to Southern Bell associated with a hurricane could range from \$30 million to \$180 million. Tr. Vol. 6, p. 86 lines 2-12. At the same time, partially as a result of the increasing risk of loss, Southern Bell is not able to view commercial insurance as an economically viable option to protect against losses to its outside plant. See testimony of Emmanuel Lauria, Tr. Vol. 5, p. 62 line 20 - p. 63 line 3. If Southern Bell were able to purchase insurance, the premiums would be considered operating expenses for regulatory purposes. Southern Bell is proposing to self-insure because such insurance is not available on an economic basis, according to the testimony of its witnesses.

The Commission believes that the Company should be allowed to establish the Casualty Reserve Fund and that the annual expense of

\$10 million is reasonable and should be granted. The Commission believes that the Company should continue to expense \$10 million annually for the fund until it reaches a total of \$50 million. This is an amount equivalent to the deductible in an insurance policy that could be obtained by the Company. See Tr. Vol. 6, page 116. Further, we believe that the Staff's position with regard to removal of said funds from rate base is also appropriate, since such monies are ratepayer funds. The Commission grants this adjustment.

The Commission has examined the position of the Consumer Advocate and the Staff in this matter. Both recommended simple deferral accounting should a hurricane or other natural disaster occur. The Commission rejects this position since Southern Bell made a strong showing, in our opinion, that self-insurance is the most economical way for it to proceed to protect its outside plant from naturally occurring weather disasters, which we believe are a very real threat to South Carolina based on the evidence. We, therefore, believe that the Consumer Advocate and Staff's position must be rejected. We also hold that the position of the South Carolina Cable Television Association which states several objections to the adjustment must be rejected since the Company clearly carried its burden on the need for the establishment of the fund.

H. Federal Tax Changes. The Company proposed to include an adjustment for changes in the federal fuel tax rates. The tax rate increased by 4.3 cents per gallon of gasoline effective

October 1, 1993.

The Staff did not accept this proposed adjustment on the basis that it was not provided with sufficient documentation to support the adjustment. Consequently, the Staff found that the adjustment was not measurable.

The Consumer Advocate agreed with the Staff's adjustment. The Consumer Advocate noted that Southern Bell's computation is based on estimated 1994 gasoline usage.

The Commission denies the Company's adjustment on the gasoline tax increase. The record does not adequately support the proposal.

Under the Omnibus Budget Reconciliation Act of 1993, the federal tax rates increased from 34% to 35% effective January 1, 1993. The Company and Staff agreed on the method of computing the adjustment to reflect this change in the tax law. The Company and Staff used taxable income as computed in Southern Bell's surveillance report as the starting point for the tax computation.

While the Consumer Advocate agreed that an adjustment should be made to reflect the change in the tax rate, the Consumer Advocate proposed a methodology different from that of the Company and the Staff. The Consumer Advocate proposes to calculate the adjustment using the Company's income taxes as its starting point to arrive at taxable income and then applying the 1% tax increase to arrive at the increase in the tax expense. The Consumer Advocate's calculation is based on Southern Bell's response to its

Interrogatory No. 4-8.⁷

The Commission concludes that the adjustment proposed by the Company and the Staff should be adopted as it provides a more exact computation of the effects of the new tax law. Unlike the Consumer Advocate's proposal, the Company and the Staff's computation includes items that need to be added or deleted to arrive at taxable income prior to applying new tax rates.

I. Accounting Changes - SFAS 106 & 112. Both the Company and the Staff proposed to amortize over fifteen (15) years the remaining transition costs resulting from adoption of SFAS 106 which allows a company to treat certain Post Retirement Benefits other than Pensions with the accrual method of accounting. These proposals increase operating expense by approximately \$721,000. The Consumer Advocate contended that the amortization should be over twenty (20), rather than fifteen (15), years because the Commission has approved a twenty (20) year amortization period for other utilities. The Consumer Advocate's adjustment increases operating expenses by \$120,000.

The Commission concludes that the fifteen (15) year amortization period is proper for Southern Bell. As noted by Staff witness Ellison, SFAS 106 allows the amortization of transition benefits over either the average remaining service life of the Company's workforce or twenty (20) years. Fifteen (15)

7. The Company's adjustment for federal tax law changes increased its operating expenses by \$1,936,897; the Staff's adjustment increased operating expenses by \$1,882,139; and the Consumer Advocate's adjustment increased operating expenses by \$1,256,000.

years represents the average remaining service life of Southern Bell's work force. Tr. Vol. 1, p. 119, lines 3-21. The Commission believes it appropriate to match the transition costs of the employees with the ratepayers who are receiving the service of those employees as closely as possible. The shorter amortization period reflects this philosophy. Therefore, the Commission adopts the Company's and the Staff's adjustment.

In addition, the Staff proposed to amortize the transition costs under SFAS 112 over five (5) years. SFAS 112 recognizes certain benefits such as workers compensation and disability payments provided to employees after employment but before retirement. The Staff proposed to amortize the transition costs associated with SFAS 112 over five (5) years, even though the accounting standard contains no provision for amortizing any transition costs, so that ratepayers are not required to absorb all of the costs within two (2) years, as proposed by the Company. The Consumer Advocate agreed with the Staff's proposal. The Staff's proposal increased the Company's operating expenses by \$1,113,841. The Company's proposal increased its operating expenses by \$2,784,500 and its rate base by \$1,719,429.

The Commission adopts the Staff's adjustment. The Commission finds and concludes that the five (5) year amortization normalizes the 1992 review period and, consequently, prevents ratepayers from absorbing all transition costs associated with SFAS 112 over a short two (2) year period. (The Company's proposed rate base adjustment is addressed in Section ii of this Order.)

J. Interest Synchronization. The Staff proposed to record the effects of interest synchronization on income taxes. The Staff proposed to increase operating taxes by \$689,459 based on BellSouth's consolidated telephone operations capital structure and embedded costs rates, as of May 31, 1994. The Staff lowered taxes by \$34,439 to update interest synchronization for pro forma rate base adjustments. The Company's interest synchronization adjustment differs from the Staff's adjustment due to differences in its proposed rate base and the use of a capital structure as of June 30, 1994.

The Commission finds that the computation of interest synchronization should be based on the rate base, embedded cost rates, and capital structure approved in this Order. Consequently, the Commission approves the Staff's methodology.

K. Account 7370. Staff proposed to remove this entire account for ratemaking purposes. The account includes contributions, abandoned projects, service club memberships, and other gains and losses. Staff's proposal reduces the Company's operating expenses by \$1,011,708.

The Company agreed with the removal of contributions expense, or \$911,655, for ratemaking purposes. However, the Company declined to remove the expenses associated with abandoned projects and service club memberships.

The Commission adopts the Staff's adjustment. The Commission concludes that costs for abandoned projects and service club dues are not necessary for the provision of telephone service and,

therefore, are not appropriate ratepayer expenses.

L. Salary and Wage Adjustments. The Company proposes a salary and wage adjustment to recognize a going forward level of salary and wage expense. The Company's adjustment recognizes annualized 1992 wage and salary increases and estimated 1993 and 1994 salary increases for first and second level managers and non-management personnel. The Company's proposal increases its expenses by \$9,435,171 and its rate base by \$1,787,331.

The Staff also proposed a salary and wage adjustment. The Staff's proposal is based on actual salaries and wages for 1993. The Staff subtracted actual 1992 per book wages from actual 1993 per book wages to arrive at an adjustment it believes represents the known and measurable change in the Company's salaries and wages. During cross-examination Staff witness Ellison explained that because employee levels decreased after the test year ended, his suggested adjustment was appropriate. Tr. Vol. 1, p. 117, line 21-p. 118, line 5. Mr. Ellison further testified that the Staff did not include the 1994 projected wage increase in its adjustment because it was not possible to apply the 1994 salary increase to a non-measurable decreased level of employees. Tr. Vol. 1, p. 89, lines 1-4. Mr. Ellison stated that the Company has proposed a work force reduction adjustment in which it states it is committed to reducing its workforce by 8,000 employees by 1996. The Staff's proposal increases the Company's expenses by \$2,331,314 and rate base by \$318,452.

The Consumer Advocate also opposed the Company's proposed

wage adjustment because it did not consider work force reductions which occurred after the review period. The Consumer Advocate opposed the Staff's adjustment insomuch as it did not consider the work force reductions which occurred in 1994. The Consumer Advocate's proposal increases the Company's expenses by \$1,266,424. The Consumer Advocate's proposal included \$42,000 as capitalized wages.

On cross-examination, the Consumer Advocate asked Mr. Ellison if the Staff would be opposed to using actual employee levels at June 1994 in order to reflect current employee levels. Mr. Ellison responded that the projected August 1994 wage increase would also need to be considered if employee levels were updated through June 1994. Tr. Vol. 1, p. 188, lines 6-17. Consumer Advocate witness Miller testified that it is appropriate to update actual employee levels with actual wage increases. Tr. Vol. 3, p. 141, line 20-p. 142, line 12.

The Commission adopts the Staff's salary and wage adjustment. The Commission concludes that the year end 1993 employee levels and associated known salary and wage increases fairly reflects the Company's salary and wage expense.⁸ The Company could only provide salary and wage estimates of its known increase in August 1994. Consequently, the Commission determines that the salary and

8. Mr. Ellison testified that application of an average increase for the August 1994 salary and wage increase to the Consumer Advocate's proposed adjustment produces approximately the same level of salary and wage expense as is included in the Staff's Report. Tr. Vol. 1, p. 118, lines 6-17.

wage levels at December 31, 1993 most fairly represent the Southern Bell's salary and wage expense.

M. Work Force Adjustment. Southern Bell proposes to include expenses associated with its work force reduction over the next several years. The Company asserts that significant outlays are necessary for employee separation costs, relocations, and redesign of computer systems. Southern Bell proposes these costs be absorbed by its ratepayers because the ratepayers will receive the benefits of the employee work force reduction. Southern Bell's adjustment increases its operating expenses by \$5,966,531.

The Staff did not accept Southern Bell's adjustment for work force reduction expenses. The Staff testified it was unable to obtain actual expenses in support of this adjustment. The Consumer Advocate supported the Staff's recommendation.

The Commission declines to adopt the Company's adjustment on work force reduction expenses on the basis that there is no documentation which sets forth Southern Bell's actual expenses to date.

N. Refinancing Costs. Southern Bell proposes to include its costs associated with obtaining refinancing of debenture issues at lower interest rates as operating expenses at the same rate as interest savings benefit ratepayers. The Company's adjustment reduces net operating income by \$2,203,219 and increases rate base by \$5,259,359.

The Staff proposed to allow Southern Bell to recover its refinancing costs by amortizing the expense over the life of the

new debt issues as an increase to cost of debt. In addition, the Staff proposed that the Company be allowed to earn a return on this investment and, therefore, included \$4,767,871 in rate base. Staff witness Ellison testified that the Staff's method provides a sharing of refinancing costs between the ratepayer and the shareholder and is consistent with the Commission's treatment of refinancing costs in prior cases. Tr. Vol. 1, p. 82, lines 7-23.

The Consumer Advocate agreed with the Staff's proposal to amortize the refinancing costs. The Consumer Advocate, however, disagreed with including the unamortized amount in rate base as working capital. It is the Consumer Advocate's position that by including the amortized costs in working capital the Company is allowed the opportunity of recovering more than 100% of the costs associated with the unamortized amounts.

The Commission adopts the Staff's adjustments for refinancing costs. First, the Commission finds it appropriate to amortize the refinancing costs over the time in which the new debt issues are outstanding. The Commission does not believe it appropriate for the utility to fully recover this cost above the line as a new expense item. Second, the Commission concludes it is appropriate to allow the utility a return on the money its shareholders invested to acquire lower debt costs. The Commission believes the accounting method adopted herein will encourage Southern Bell to seek out debt with lower interest rates, thereby lowering its embedded cost of debt over time and benefiting both the shareholders and the ratepayers. The benefits of a lower debt

cost are apparent in this proceeding. The test year cost of debt was higher than the cost of debt approved for use in this proceeding. The Consumer Advocate's argument to the contrary, this method does not allow Southern Bell to overrecover its costs but it does allow the Company to earn a return on its investment in refinancing costs.

O. Environmental Clean-Up Costs. The Company proposes to recover the estimated cost of repair and upgrading of fuel tanks to comply with environmental standards. The Company's proposal includes updated costs to recognize additional remediation expenses identified during 1993. The Company's recommendation increases its expenses by \$349,595. The Company requests that if the Commission amortizes these costs, it do so over a two (2) or three (3) year period. The Company testified that a three (3) year amortization decreases its net operating income by \$215,875.

The Staff proposes to amortize the total Company liability for environmental clean-up costs over a five (5) year period. Staff witness Ellison testified that the five (5) year amortization is appropriate to normalize the 1992 review period. Tr. Vol. 1, p. 80, line 24-p. 81, line 1. The Staff computed the total Company liability of \$8,821,040 based on cost estimates received by the Company from third parties. Staff witness Ellison testified that, pursuant to FASB Statement No. 5, when it is probable that a utility has incurred a liability and that liability can be reasonably estimated, the utility is required to

accrue the liability on its books. Tr. Vol. 1, p. 107, line 13-p. 108, line 8. The Staff's adjustment is a \$539,987 decrease to intrastate operating expenses.

The Consumer Advocate disagrees with both the Company and the Staff on this adjustment. The Consumer Advocate contends that the Company should only be able to recover its actual expenses of \$105,686 for environmental clean-up and that it is inappropriate to recognize in rates estimates of future clean-up expenses. The Consumer Advocate's adjustment is a \$2,376,000 decrease to intrastate operating expenses.

The Commission adopts the Staff's adjustment. The Commission concludes that Southern Bell has the obligation of repairing and upgrading fuel tanks to comply with environmental standards. The Commission further finds that use of clean-up estimates from third parties is sufficient for this purpose for establishing the amount of Southern Bell's liability. Consequently, the Commission finds it appropriate to true-up Southern Bell's books to recognize the liability for environmental expenses as prescribed by FASB Statement No. 5. The Commission further concludes that this liability should be amortized and recognized as an expense over a five (5) year period. The Commission finds a five (5) year amortization period fair and reasonable.

P. Asbestos Removal and a Related Lawsuit. The Staff proposed to amortize \$313,400 in asbestos removal costs and \$121,853 in legal fees defending an asbestos related lawsuit over five (5) years in order to normalize the 1992 review period. The

Staff's adjustment lowered intrastate expenses by \$249,699. The Consumer Advocate agreed with the Staff's adjustment.

The Company recorded the 1992 asbestos related expenses as operating expenses on its surveillance report. The Company proposed no adjustment. In his testimony, however, Company witness Killingsworth testified that if the Commission chooses to amortize these costs, it should do so over a two (2) or three (3) year period.

The Commission adopts the Staff's proposal. The Commission concludes that a five (5) year amortization fairly adjusts the 1992 review period expenses to reflect a normal test year. Moreover, the Commission notes that a five (5) year amortization period is consistent with other amortization periods in this Order.

Q. Lobbying. The Staff proposed to eliminate lobbying expenses which the Company proposed to recover through rates. The Staff's adjustment reduced operating expenses by (\$18,251). In addition, the Staff proposed to reduce from legal expenses activities relating to monitoring, analysis, interpretation, and review of various legislation. The Staff testified it did not believe these expenses were necessary for the provision of telephone service. Staff's adjustment reduced expenses by (\$95,009).

The Commission adopts the Staff's adjustment. The Commission concludes lobbying expenses are not necessary for the provision of telephone service.

R. Consultation Fees. The Staff proposed to amortize over three (3) years consultant fees incurred by BellSouth Telecommunications, Inc. for reorganizing certain Company functions. The Staff's adjustment reduces the Company's expenses by \$305,333. The Company proposed to recover the consultant fees in one year on the basis that the fees are part of its effort to manage costs.

The Commission concludes that a three (3) year recovery of consultation fees is appropriate. Therefore, the Commission adopts the Staff's adjustment.

S. Hurricane Andrew Expenses. The Staff proposed to disallow costs incurred by Southern Bell for assistance with Hurricane Andrew. The Staff explained that costs for Hurricane Andrew should be charged to those ratepayers (i.e. Southern Bell's Florida customers) who benefited from the expense. The Staff's adjustment lowers expenses by \$112,583 and rate base by \$6,852. The Company did not adjust its 1992 surveillance report to remove costs associated with Hurricane Andrew.

The Commission finds it would be inappropriate to require South Carolina's ratepayers to absorb the costs for Southern Bell's assistance in Hurricane Andrew. The Commission notes that other states charged Hurricane Hugo costs back to South Carolina. The Commission finds Hurricane Andrew costs should be treated similarly and, therefore, adopts the Staff's adjustment.

T. Officer Pay Increases. The Staff proposed to remove officer pay increases and incentive compensation payments from the

1992 review period. The Staff explained that officer incentive compensation payments are possibly non-recurring in that it is not definite that officers will meet yearly incentive goals, disallowance of these increases prevents utilities from providing officers with large wage increases or incentive compensation payments to help justify rate relief or prevent rate reductions, and the adjustment promotes a sharing of salaries and wages between the ratepayer and the shareholder. The Staff's adjustment reduced the Company's expenses by \$202,298.

The Company disagreed with the Staff's adjustment. The Company testified that its officers' salaries are comparable to those of like businesses and are a normal operating expense.

The Commission adopts the Staff's adjustment. The Commission concludes that compensation payment levels may not be recurring as it is not known whether officers will qualify for the incentive each year.

U. Nonallowables. The Staff proposed to disallow various items the Commission has routinely classified as being nonallowable for ratemaking purposes. As a general rule, the Staff disallowed these expenses because they were considered unnecessary for the provision of telephone service. Specifically, the Staff disallowed the following items:

1. Employee newsletters and bulletins. The Staff disallowed these forms of employee communication because they often duplicate information dispersed through formal corporate channels. (See

discussion at Section A(i)(F) of Order).

2. Employee gifts and awards. The Staff eliminated sales incentive awards, safety and length of service awards, and other miscellaneous gifts and awards.
3. Membership dues and fees. The Staff eliminated dues and fees for membership in business leagues, clubs, Chambers of Commerce, and other organizations not directly related to job functions. In addition, the Staff eliminated the nonallowable portion of dues paid to the South Carolina Telephone Association and the United States Telephone Association for items which do not directly benefit ratepayers.
4. Miscellaneous. Staff eliminated the cost of flowers, contributions, sponsorships, novelty items, luncheons, and voluntary payments.
5. Image Building Advertisements. Staff eliminated the cost of advertisements which appeared to be institutional or image building in nature.

The Staff adjustment reduced the Company's operating expenses by \$1,134,246 and rate base by \$67,273.

The Company disagreed with the Staff's proposed adjustment for nonallowables. The Company asserted that the Staff capriciously disallowed legitimate business expenses.

With the exception of Chamber of Commerce dues, discussed below, the Commission finds that the Staff appropriately disallowed items which are not necessary for the provision of telephone service and, therefore, should not be ratepayer expenses.

However, the Commission does find that one-half ($\frac{1}{2}$) of the dues paid by Southern Bell to state and local Chambers of Commerce⁹ should be included in cost of service. The Commission concludes that Southern Bell's participation in Chambers of Commerce is of value and benefit to the community as Chambers of Commerce provide access to services for small businesses which they would not have otherwise. Moreover, Chambers of Commerce improve community images. Consequently, the Commission concludes that one-half ($\frac{1}{2}$) of the dues paid by Southern Bell to state and local Chambers of Commerce should be included in rates.

V. BellSouth Expenses. Similar to its treatment of nonallowables, the Staff removed certain expenses allocated to Southern Bell from BellSouth Corporation. These items include national lobbying, awards, business gifts, spousal expenses for travel, entertainment expenses, and sponsorships. The Staff's adjustment reduced the Company's expenses by \$44,367. The Company disagreed with the Staff's treatment of these expenses.

The Commission adopts the Staff's adjustment. The Commission concludes that the items included in this allocation are not necessary for the provision of telephone service.

9. This amount is \$38,366.

W. Special Service Assembly Arrangements. The Staff proposes to annualize the contributions associated with approximately fifty (50) Special Service Arrangements between Southern Bell and its subscribers which were approved by the Commission during the 1992 review period. The Staff's proposal increases the Company's revenues by \$195,897.

The Company disagreed with the Staff's adjustment. Southern Bell testified that the revenues associated with Special Assembly contracts are already included in its reported earnings and, further, that the revenues from these contracts replace an ongoing tariffed revenue system.

The Commission adopts the Staff's adjustment. The Commission finds that Staff's adjustment which annualizes the effect of Special Service Arrangements appropriately reflects the actual year-long effect of revenues from these contracts.

X. Customer Growth. The Staff proposed to adjust for customer growth by using a method which reflects the changing revenues and expenses during the period January 1, 1992, through May 31, 1994. The Staff's proposal is consistent with its other adjustments made for outside of test year changes. The Staff's proposal increases net operating income by \$4,585,272.¹⁰

The Consumer Advocate's customer growth adjustment utilizes an average customer component comprised of the average customers

10. The Commission recognizes that the actual growth adjustment will differ from this amount due to changes in Net Operating Income for adjustments approved herein.

between January 1, 1992, and December 31, 1992. The Consumer Advocate then used such customer average and the June 30, 1994 access lines in his customer growth formula. The Consumer Advocate's adjustment increases net operating income by \$9,986,000.

The Commission adopts the Staff's adjustment. The Commission concludes that the Staff's adjustment properly reflects a matching of revenues and expenses while the Consumer Advocate's proposal fails to recognize its own adjustments which are outside the review period. The Commission finds that the Consumer Advocate's method is inappropriate because the average customers used in this approach constitutes an inconsistent use of the customer growth formula. The average used by the Consumer Advocate does not encompass the end of period customers required by the Commission's standard formula. Since adjustments were made outside of the test year, it is appropriate to use customers outside of the test year in developing the average to be used in the growth formula.

Y. BellSouth Regional Audit Expenses. The Consumer Advocate proposes to reduce the Company's expenses allocated from BellSouth by \$1,215,885 to reflect the findings of a regional audit conducted by the BellSouth Policy Management Group. The BellSouth Policy Management Group was formed by representatives from the Florida, Tennessee, Louisiana, and South Carolina Commissions.

On cross-examination the Consumer Advocate inquired into Staff witness Ellison's participation in the regional audit. Mr. Ellison stated that another staff accountant had participated in the audit but that he had not reviewed any work papers associated with the

audit. Tr. Vol. 1, p. 103, lines 3-22.

The Commission denies the Consumer Advocate's proposed adjustment. The Commission believes it would be inappropriate to make adjustments to Southern Bell's books based on an audit in which the Staff did not perform the actual calculations or review the work papers. Additionally, the Company's responses to the audit were not made available for the Commission's review.

Z. Uncollectible Expenses. The Staff and the Company did not propose an adjustment to the review period's uncollectible expenses. The Consumer Advocate, however, proposed to adjust the uncollectible revenues on the basis that the 1992 write-offs were higher than calendar years 1989-1991 and 1993. The Consumer Advocate proposes that the Commission adjust the test year expense by using the latest known net uncollectible write-off factor. The Consumer Advocate's proposal lowers the Company's expenses by \$3,036,000.

The Commission denies the Consumer Advocate's adjustment. The Commission concludes that the Consumer Advocate has not demonstrated that BellSouth Telecommunications, Inc.'s system-wide uncollectible ratio is representative of Southern Bell's uncollectible ratio.

AA. Economic Development Discounts. The Consumer Advocate requests the Commission continue to track any revenues foregone by Southern Bell as a result of its economic development discount tariff and treat any revenues waived as a shareholder expense. The Commission grants this request. The Commission will track any

foregone revenues as a result of the economic development discount tariff, treat any foregone revenues as a shareholder expense, and review this information at a later time.

AB. Adjustment to Flow Back Excess Unprotected Accumulated Deferred Income Taxes. The Staff proposed the flow back of excess unprotected accumulated deferred income taxes to ratepayers over a maximum period of five (5) years which is in accordance with past rulings of the Commission in major utility cases. The adjustment was made in the previous case involving this utility. (See Docket No. 90-626-C, Order No. 91-595, p. 25.) The Company proposed no adjustment.

The Commission believes that the evidence supports an expedient flow back of these unprotected excess deferred income taxes. The Commission finds that the expedient flowback of unprotected excess accumulated deferred income taxes over a five (5) year period is appropriate. This is permissible because Section 203(e) of the Internal Revenue Code under the Tax Reform Act of 1986 which discusses the excess deferred income taxes that relate to the tax timing differences created by the use of liberalized depreciation is not applicable to these taxes. The Commission hereby adopts Staff's adjustment to reduce income tax expense by \$283,709 representing such excess unprotected deferred income taxes for the test period. The Commission agrees with the Staff that Accumulated Deferred Income Taxes should be reduced by the same amount. The Commission finds that the ratepayers will benefit from a quicker recovery of these taxes. [See discussion in

Section ii (A).]

Based upon its findings of appropriate operating revenues and operating expenses, the Commission concludes that the appropriate level of net operating income for return after accounting and pro forma adjustments is \$124,372,402. This calculation is shown in Table A.

TABLE A

NET INCOME FOR RETURN BEFORE RATE DECREASE

	\$
Operating Revenues	645,195,001
Operating Expenses	525,230,986
Net Operating Income	119,964,015
Interest During Construction	17,704
Customer Growth	4,390,683
Net Operating Income for Return	<u>124,372,402</u>

ii. Rate Base Items

Pursuant to S.C. Code Ann. §58-9-570(1976), in ratemaking proceedings involving a telephone utility, the Commission must "give due consideration to the telephone utility's property devoted to the public service..." Such consideration is traditionally made in the context of the determination of the utility's rate base.

For ratemaking purposes, the rate base represents the total net value of the telephone utility's tangible and intangible capital or property value on which the telephone utility is entitled to earn a fair and reasonable rate of return. Generally, the rate base, as allocated to the Company's South Carolina intrastate operations, is composed of the value of the Company's

property used and useful in providing telephone service to the public, plus construction work in progress, materials and supplies, an allowance for cash working capital, and property held for future use. The rate base computation incorporates reductions for the reserve for depreciation and amortization (accumulated depreciation), accumulated deferred income tax, contributions in aid of construction and customer deposits. The Accounting Department of the Administration Division of the Commission Staff, prior to the date of the hearing, conducted an audit and examination of the Company's General Ledger, including rate base items, with plant additions and retirements.

In the instant proceeding, the Commission Staff conducted an analysis of the items and amounts which the Company proposed to be included in its intrastate rate base for ratemaking purposes. On the basis of the Staff's audit, the exhibits and testimony of all parties contained in the evidentiary record of the proceeding, the Commission can determine and find proper balances for the components of the Company's rate base, as well as the propriety of related accounting adjustments. This Commission has traditionally determined the appropriate rate base of the affected utility as of the end of the test period. See e.g. Order No. 85-1, Docket No. 84-308-C. This Commission is among the majority of regulatory agencies which provides for the determination of a utility's rate base on a "year end" basis, a result which most reasonably coincides with the prospective operation of any ratemaking action. The use of a "year end" rate base likewise serves to enhance the

timeliness of the effect of such action and preserves the reliance on historic and verifiable accounts without resort to speculative or projected figures. Consequently, the Commission finds it most reasonable to retain its consistent regulatory practice herein and evaluate the issues in this proceeding founded on a rate base for the Company's intrastate operations as of December 31, 1992.

A. Amortization of Excess Unprotected Surplus Taxes. The Staff proposed to amortize the Company's excess unprotected accumulated deferred surplus taxes to more quickly return to the ratepayer the taxes associated with unprotected assets. The Staff's proposal lowers Accumulated Deferred Income Taxes by \$283,709 which increases rate base by a like amount. The Company disagreed with this proposal and suggested that ratepayers be returned the deferred taxes when the tax payments become due.

The Commission finds it is within its authority to return to the ratepayer the excess unprotected accumulated deferred income taxes over a five year period rather than over the life of the asset or when the tax payment becomes due. Therefore, the Commission adopts the Staff's adjustment.

The Consumer Advocate's assertion that a rate base adjustment should not be made is without merit. The adjustment for accumulated deferred income taxes was made by the Staff to correct the book figures of the Company to reflect a treatment which was previously approved by this Commission. The correction should be carried out in its entirety which includes the rate base effect. The argument concerning inconsistent treatment with the

depreciation expense adjustment is not acceptable. The depreciation adjustment in this case was a pro forma adjustment to lower depreciation expense. The depreciation adjustment is not a correcting adjustment in this case. Therefore, the offset to accumulated depreciation is not required.

B. Unamortized Accounting Changes. The Company proposed to include unamortized accounting changes associated with FAS 112, Employers Accounting for Post Employment Benefits, into rate base. The Staff and the Consumer Advocate did not propose a rate base adjustment for the unamortized portion of this expense. The Commission notes that the expense impact of FAS 112 results from a change in the method of accounting for these costs from a "pay as you go" method to an accrual method.

The Commission finds that the change in accounting method produces a regulatory asset which will be recovered by the Company over a five year period as an above the line expense. However, the Commission will not approve rate base treatment for such regulatory asset. The Commission finds that such regulatory asset is not used and useful in providing service to the ratepayer and is, therefore, not appropriate for inclusion in rate base. See Part A (i)(I) of this Order.

C. Cash Working Capital. The Consumer Advocate proposes to include a zero cash working capital allowance in rate base. The reasoning behind the Consumer Advocate's approach is that a lead lag study would show that the Company has no cash working capital requirement. A summary of a lead lag study prepared by Southern

Bell for calendar year 1993 was attached to witness Miller's testimony. Hearing Exhibit No. 7. Mr. Miller testified that this study shows a negative cash working capital requirement. Mr. Miller also stated that a lead lag study was not conducted for this proceeding and that the 1993 study was not completed and applied to 1992 results.

The Company and the Staff did not propose to include cash working capital based on the Commission's standard formula for telephone companies. Instead, a formula method based on average daily cash balances and working funds was employed. This method is the same method which has been used by the Commission in past cases involving this utility. The Staff's proposal increases rate base by \$3,453,500.

The Commission denies the Consumer Advocate's proposal. This Commission has never required a utility to support its cash working capital requirement with a lead lag study and has opted to utilize the formula approach in past cases involving telephone utilities. The Commission finds that the formula approach as calculated by the Staff is appropriate for use in this case as well. Moreover, the Commission concludes that the lead lag study on which the Consumer Advocate requests this Commission to adopt its proposal is incomplete and, therefore, inappropriate for consideration.

D. Other Rate Base Items. The Commission notes that many revenue and expense adjustments addressed earlier in this Order have a corresponding affect on Southern Bell's rate base. The Commission has not specifically addressed the rate base treatment

of proposed adjustments it has previously discussed.

iii. Miscellaneous Adjustments and Taxes

All other adjustments agreed to by the parties and not specifically addressed herein are approved. All other adjustments proposed by the Staff and not previously addressed are approved. All other adjustments inconsistent with the adjustments in this Order are denied. General, state, and federal taxes are adjusted to reflect the adjustments approved by the Commission in this Order.

The Commission has previously discussed the differences between the Company, the Staff and other parties in their respective rate base computations. It is the opinion of the Commission that the South Carolina intrastate rate base at December 31, 1992, as adjusted, of \$980,027,652 is both reasonable and appropriate. That rate base is shown below:

TABLE B
ORIGINAL COST RATE BASE
SOUTH CAROLINA INTRASTATE OPERATIONS
DECEMBER 31, 1992

Telephone Plant in Service	\$1,779,432,007
Accumulated Depreciation	(648,234,200)
Net Telephone Plant in Service	<u>1,131,197,807</u>
Telephone Plant Under Construction	17,128,824
Property Held for Future Use	-0-
Materials and Supplies	14,130,293
Cash Working Capital	3,381,565
Unamortized Debt Refinancing Costs	4,767,871
Casualty Reserve - Net	(6,175,000)
Accumulated Deferred Income Taxes	(179,786,165)
Customers' Deposits	(4,512,037)
Advances in Aid of Construction	(105,506)
Total Rate Base	<u><u>980,027,652</u></u>

5. In order to provide the Company with an opportunity to earn a fair and reasonable return on its South Carolina investment, the Commission must determine what capital structure is appropriate for ratemaking purposes. The Company, the Consumer Advocate, and the Staff propose that BellSouth Telecommunications, Inc.'s regulated capital structure and debt cost rates be utilized in this proceeding.¹¹ The Company and Consumer Advocate propose viewing the capital structure of BellSouth at June 30, 1994, while the Staff proposes viewing the capital structure at May 31, 1994. The Staff also recommends the Commission adjust the capital structure to reflect its adjustment on refinancing costs.

The Commission concludes that the regulated capital structure and debt cost rates of BellSouth Telecommunications, Inc. at May 31, 1994, provides a useful proxy for Southern Bell in this proceeding. Moreover, the Commission finds the capital structure at May 31, 1994 appropriate in that the figures for that date were available for all parties at the time of their audits. The Commission further finds that the capital structure should be adjusted to reflect the Commission's ruling on refinancing costs. See Part 4(A)(i)(N) of Order.

Using the May 31, 1994 figures, the Company's capital structure consists of long term debt and common equity. The

11. BellSouth Telecommunications, Inc. is a wholly-owned subsidiary of BellSouth Corporation. BellSouth Telecommunications, Inc. was formed on January 1, 1992, by Southern Bell Telephone and Telegraph Company, South Central Bell Telephone Co., and BellSouth Services, Inc. Tr. Vol. 2, lines 12-20.

embedded cost rate for long term debt is 7.47%.

6. One of the principal issues in any ratemaking determination involves the proper earnings to be allowed on the common equity investment of the regulated utility. In this proceeding, the Commission was offered the expert testimony of witnesses relating to the fair and reasonable rate of return on common equity for the Company. These financial experts presented detailed explanations of a number of methodological approaches to the determination of the cost of equity capital.

The Commission's analysis of the evidence regarding the appropriate return on equity in this case must be guided by the constitutional principles set forth by the Supreme Court of the United States in Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, and Federal Power Commission v. Hope Natural Gas Company, supra. These tests can be summarized as follows:

1. The allowed return on common equity should be the same as that earned on other investments of comparable risk.
2. The allowed return should be sufficient to maintain the utility's credit standing and enable it to raise necessary capital.
3. A reasonable return may vary over time reflecting changing economic conditions.

While the Commission adheres to no particular theory or methodology for the determination of a fair rate of return on common equity, it does test the various recommendations before it against these constitutional standards to determine the

reasonableness of the approaches proposed by the various parties. With these legal standards in mind, the Commission is able to fulfill its function of engaging in a careful analysis of the economic and financial theories before it for application within a regulatory context.

The Commission heard the testimony of three witnesses on return on equity. Dr. Randall S. Billingsley, Associate Professor of Finance at Virginia Polytechnic Institute and State University, testified on behalf of Southern Bell. Dr. John B. Legler, Professor of Banking and Finance at the University of Georgia, appeared on behalf of the Consumer Advocate. Dr. James E. Spearman, Assistant Public Utilities Economist, testified on behalf of the Staff.

Dr. Billingsley applied a Discounted Cash Flow analysis and a Risk Premium analysis to determine the appropriate return on equity. The Discounted Cash Flow analysis produced a cost of equity in the range of 12.97% to 13.14%. The Risk Premium analysis resulted in a return on equity ranging from 14.65% to 14.68%. Dr. Billingsley recommended a range for the return on equity of 13.06% to 14.67%, with a midpoint of 13.87%. A stock flotation cost adjustment of 27 basis points was included in his estimates.

Dr. Legler utilized a Discounted Cash Flow analysis, a Risk Premium analysis, and a Capital Asset Pricing Model analysis. The Discounted Cash Flow analysis produced returns on equity ranging from 9.6% to 14.43%. The Risk Premium analysis resulted in returns on equity in the range of 10.81% to 12.03%. Based on the

Capital Asset Pricing Model analysis, the return on equity ranged from 12.00% to 14.52%. Dr. Legler recommended a return on equity of 11.5% to 12.0%. No flotation cost adjustment was included in his recommendation, as Dr. Legler believed such an adjustment to be unnecessary.

Dr. Spearman applied a Discounted Cash Flow analysis and a Capital Asset Pricing Model analysis. The Discounted Cash Flow analysis produced a return on equity in the range of 7.68% to 15.09%. Based on the Capital Asset Pricing Model analysis, the return on equity ranged from 11.87% to 12.71%. Dr. Spearman recommended a return on equity in the range of 12.0% to 12.5%. No flotation adjustment was included as Dr. Spearman determined that neither Southern Bell nor its parent company has recently publicly issued common stock or intends to publicly issue stock in the next few years and, therefore, a flotation cost adjustment would be inappropriate.

The Commission notes that each of the witnesses based their analyses on data from the summer of 1994. Economic conditions and actions by the Federal Reserve Board have resulted in much uncertainty in the financial markets. Long-term interest rates have risen approximately 50 basis points since these analyses were performed and many analysts forecast further increases in interest rates. Currently, long-term interest rates approximate 8.0%, which is slightly above the interest rate used by Staff witness Dr. R. Glenn Rhyne in his analysis of Southern Bell's return on equity in Docket No. 90-626-C when a 13.0% benchmark return on equity for

Southern Bell was approved by this Commission.

Based on the evidence presented by the witnesses and current economic conditions, the Commission adopts a 13.0% return on common equity as appropriate for the setting of rates for Southern Bell. The Commission also determines that no flotation cost adjustment is warranted at this time. A 13.0% return on equity allows for the uncertainty in the financial markets and rising interest rates which have occurred since the return on equity analyses were performed. It also falls at the lower end of witness Dr. Billingsley's recommended range when flotation costs are excluded. Although a 13.0% return on equity is above the recommended ranges of both witness Dr. Legler and witness Dr. Spearman, it is within the upper limits determined by their analyses.

The Commission considers the value of 13.0% to represent a reasonable expectation for the equity owner, and, therefore, consistent with the standards in the Hope decision. A rate of return on rate base found fair and reasonable is sufficient to protect the financial integrity of the Company, to preserve the property of the investor, and to permit the Company to continue to provide reliable services to present and future customers at reasonable rates.

In arriving at a rate of return herein, the Commission is primarily concerned only with the return to be earned on the common equity allocated to that portion of the Company's operations subject to the Commission's jurisdiction in this proceeding. The Commission has made its findings based on the jurisdictional South

Carolina intrastate operations of the Company.

An important function of ratemaking is the determination of the overall rate of return which the utility should be granted. This Commission has utilized the following definitions of "rate of return" in previous decisions, and continues to do so in this proceeding:

For regulatory purposes, the rate of return is the amount of money earned by a regulated company, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock, the earnings on common stock and surplus. As Garfield and Lovejoy have put it "the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained to surplus."

Phillips, The Economics of Regulation, pp. 260-261 (1969).

The amount of revenue permitted to be earned by the Company through its rate structure depends upon the rate base and the allowed rate of return on the rate base. As previously discussed, the primary issue between the regulated utility and regulatory body most frequently involves the determination of a reasonable return on common equity, since the other components of the overall rate of return, i.e., cost of debt and appropriate capital structure, are most easily established. Although the determination of the return on common equity provides the necessary component from which the rate of return on rate base can be derived, the overall rate of return, as set by this Commission, must be fair and reasonable.

The United States Supreme Court's landmark decisions in

Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, also delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court stated:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertaking which are attended by corresponding risk and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally.

262 U.S. at 692-693.

During the subsequent year, the Supreme Court refined its appraisal of regulatory precepts. In its frequently cited Hope decision, supra, the Court restated its view:

We held in Federal Power Commission v. Natural Pipeline Gas Co.....that the Commission was not bound to the use of any single formula or combination of formulae in determining its rates. Its ratemaking function, moreover involves the making of 'pragmatic adjustments' (citation omitted).... Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed which is controlling (Citations omitted)....

The ratemaking process under the Act, i.e., the fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case, that regulation does not insure that the business shall produce net revenues. (Citations omitted).

But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. (Citation omitted). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.

320 U.S. at 602-603.

The vitality of these decisions has not been eroded, as indicated by the language of the more recent decision of the Supreme Court in IN RE: Permian Basin Area Rate Cases, 390 U.S. 747 (1968). This Commission has consistently operated within the guidelines set forth in the Hope decision.

The Commission has found that the capitalization ratios as of May 31, 1994, as adjusted, are appropriate and should be used in the instant proceeding. The Commission has likewise found that the respective embedded cost rates for long-term debt of 7.47% should be utilized in the determination of a fair rate of return. For the purposes of this proceeding, the Commission finds the proper cost rate for the Company's common equity capital to be 13.0%.

Using these findings, the overall rate of return on rate base

for the Company's South Carolina intrastate operations may be derived as computed in the following Table:

TABLE C
OVERALL RATE OF RETURN

	<u>RATIO</u> %	<u>COST</u> %	<u>WEIGHTED COST</u> %
Long Term Debt	35.78	7.47	2.67
Common Equity	64.22	13.00	8.35
Total	<u>100.00</u>		<u>11.02</u>

7. The Commission concludes that the Company's current net income, after accounting and pro forma adjustments approved herein, is \$124,372,402 as shown on Table D below:

TABLE D
CURRENT NET INCOME
AFTER ADJUSTMENTS

<u>Rate Base</u>	<u>Embedded Cost</u>	<u>Overall Cost/Rate</u>	<u>Net Income</u>
\$350,653,894	7.47%	2.67%	\$ 26,193,846
<u>629,373,758</u>	<u>15.60%</u>	<u>10.02%</u>	<u>98,178,556</u>
<u>\$980,027,652</u>		<u>12.69%</u>	<u>\$124,372,402</u>

The Commission finds that, in order to have the opportunity to earn the 13.0% return on equity approved herein, Southern Bell's revenues should be lowered to \$619,221,255, thereby reducing its net operating income to \$108,012,435. See Table E.

TABLE E
NET OPERATING INCOME FOR RETURN
AFTER RATE DECREASE

Operating Revenues	\$619,221,255
Operating Expenses	515,039,574
Net Operating Income	<u>104,181,681</u>
Interest During Construction	17,704
Customer Growth	3,813,050
Net Operating Income For Return	<u>\$108,012,435</u>

Consequently, after examination of the overall subject of Southern Bell's earnings for 1992, the Commission has determined that rates should be reduced prospectively to Southern Bell's consumers in the amount of \$25,973,746 effective on the date of this Order, except as to numbers 3 and 5 below. The Commission has considered each parties' proposal regarding the method in which reductions should be implemented. The Commission concludes that rate reductions on a prospective basis are to be made in the following manner:

1. The current rate for Touchtone service shall be reduced by 50%.
2. The monthly recurring charge for Caller ID per line blocking for those customers who subscribe to non-listed or non-published numbers shall be eliminated.
3. Southern Bell shall initiate the process to establish the Lifeline program for its subscribers in South Carolina.
4. Intrastate access rates shall be reduced by \$12

million. This reduction is to be applied to reducing originating CCLC to interstate levels. Any residual amount is to be applied to reduce terminating CCLC.

5. Local service rates shall be lowered.

The balance of the rate reduction of \$25,973,746, including potential regrouping, is to be used to lower local service rates. Southern Bell is hereby ordered to provide a proposed plan for accomplishing this goal to this Commission within five (5) days of the date of this Order. Other parties may respond to Southern Bell's proposal within five (5) days after filing of the Company's proposal.

8. Finally, the Commission determines that it is within its authority and appropriate to order Southern Bell to issue refunds to its ratepayers to reflect its overearnings for the first year during which it was under incentive regulation. As stated in Hamm v. Central States Health and Life Co. of Omaha, 299 S.C. 500, 386 S.E.2d 250 (1989), a company "cannot keep funds to which it was never entitled." Id. at 254. The Commission concludes that the South Carolina Supreme Court's reversal of the generic incentive regulation plan on the basis that this Commission lacked the statutory authority to establish the incentive regulation plan as adopted and the subsequent reversal of Southern Bell's specific incentive regulation plan prevents Southern Bell from retaining its overearnings under incentive regulation. See, South Carolina Cable Television Association, supra.

The evidence of record indicates that in 1992 Southern Bell earned 17.31%, after accounting adjustments, under its incentive regulation plan. Southern Bell's approved rate of return on common equity was 13.0%. Southern Bell overearned in 1992 by \$36,282,603, therefore, Southern Bell is ordered to make refunds in that amount. The Commission finds that this amount should be adjusted by \$7,637,995 to reflect Southern Bell's voluntary refund issued in December 1993 and January 1994. Consequently, the net amount to be refunded by Southern Bell is \$28,644,608. The Commission has considered all parties' recommendations as to the method of accomplishing refunds and finds the Consumer Advocate's method persuasive. Therefore, the Commission adopts the Consumer Advocate's method. Southern Bell's refund shall be made by a one-time credit to all residential and business customers.

Southern Bell may choose not to issue this refund until appeals of this Order, if any, are exhausted. Interest at 12% per annum, however, shall accrue on the refund amount until all appeals are exhausted. Parties to this proceeding will have ten (10) days from the date of this Order to file positions as to when the interest calculation should commence.

Finally, the Commission declines to earmark any refund monies to OIR for telemedicine or other public purpose. As noted by this Order, the Commission has adopted the Consumer Advocate's proposal on refunds by ordering a one-time credit for all residential and business customers. Nonetheless, the Commission commends OIR for its informative testimony concerning the consolidation of the State

telephone networks, public health services, and distance learning in this proceeding.

CONCLUSIONS OF LAW

1. Southern Bell is a corporation authorized to conduct a public utility business in the State of South Carolina. The Company is a subsidiary of BellSouth Telecommunications, Inc.

2. The Company's present rates and charges were approved by Order Nos. 91-595 (August 20, 1991) and 92-89 (February 24, 1992) in Docket No. 90-626-C.

3. The Company owns and operates exchanges and lines providing local exchange and intraLATA toll telephone service to access lines located throughout South Carolina.

4. The review period for this investigation is the twelve months ending December 31, 1992.

5. The appropriate operating revenues for the Company for the review period under its present rates and after accounting and pro forma adjustments are \$645,195,001.

6. The appropriate operating expenses for the Company's intrastate telephone operations for the review period under its present rates and after accounting and pro forma adjustments are \$525,230,986.

7. The Company's appropriate level of net operating income for return after accounting and pro forma adjustments is \$124,372,402.

8. A year-end original cost, South Carolina intrastate rate base of \$980,027,652 consisting of the components set forth in

Table B of this Order, should be adopted.

9. The capital structure utilized by the Commission in this proceeding for its determination of the Company's proper level of return on common equity is the BellSouth Telecommunications, Inc. capital structure as of May 31, 1994.

10. That Staff's embedded cost rates for long-term debt of 7.47% as of May 31, 1994, should be used in the determination of a fair, overall rate of return.

11. The reasonable rate of return on common equity that the Company should be allowed to earn is 13.0% which is adopted by the Commission for this proceeding. Combined with the debt and the capital structure set forth above, the Commission finds the reasonable, overall rate of return is 11.02%

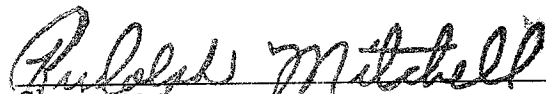
12. Based on review of the Company's appropriate operating revenues, expenses, and net operating income for return after accounting, pro forma adjustments, capital structure, and rate of return on common equity established herein, Southern Bell's rates should be reduced prospectively by the amount of \$25,973,746. The rate reduction shall be effective with the date of this Order (except as to local rates) and be made in the manner as set forth by this Order. Southern Bell shall provide a plan to reduce local rates by the remaining balance of the rate reduction in accordance with the schedule set forth in this Order.

13. Southern Bell shall issue refunds in the amount of

\$36,282,603¹² through a one-time credit on the bills of residential and business subscribers. Southern Bell may elect to postpone this refund until appeals, if any, in this proceeding have been exhausted. Interest at 12% per annum shall accrue on the refund amount. Parties may file briefs in accordance with the schedule in this Order indicating when interest shall begin to accrue.

IT IS SO ORDERED.

BY ORDER OF THE COMMISSION:


Chairman

ATTEST:


Executive Director

(SEAL)

Commissioner Warren D. Arthur, dissenting. I voted against the decision on the Southern Bell overearnings case for a number of reasons. I was not against the decision totally; in fact, I was very much in favor of the Lifeline program being put into effect. However, there exist a number of matters in the Commission's decision today that I do not believe are in the best interest of the public.

I believe that a rate of return of 13% is excessive. I feel that the rate of return should not exceed 12.5%, which is the high end of the range as presented by the Commission Staff and which is

12. Southern Bell has already refunded \$7,637,995 of this amount.

50 basis points higher than what was recommended by the Consumer Advocate and the Cable Television Association.

I do not think that the \$7.5 million which the Commission included for the Area Plus plan should have been allowed. At the hearing on the Area Plus plan, Southern Bell led the Commission to believe that it would not seek rate relief due to the implementation of Area Plus. Further, the Commission Staff recommended disallowance of the adjustment for the Area Plus plan because the adjustment was not a known and measurable change.

I am also opposed to the inclusion of \$12 million in prospective rate reductions to reduce access charges. My opposition is based on the fact that the money will go to out of state long distance companies and will negatively impact the 60% of South Carolina residential customers who make no long distance telephone calls in a given month.

With regard to the Chamber of Commerce dues, I strongly object to the Commission making value judgments regarding what is good enough for the community to be included in rates. This sets a bad precedent. There are many, many other things which Southern Bell does which are of great value to the community. The Staff recommended the Commission disallow Chamber of Commerce dues and other items which are not necessary for the provision of telephone service. It is my opinion that Chamber of Commerce dues should be treated consistently with the Staff's position and be disallowed as a ratepayer expense in this case.

Lastly, I have a general objection to trying to take up a case

with issues as complex and far reaching as this case in one
Commission meeting.